Martin Wolf: Asia is footing the bill
By Martin Wolf
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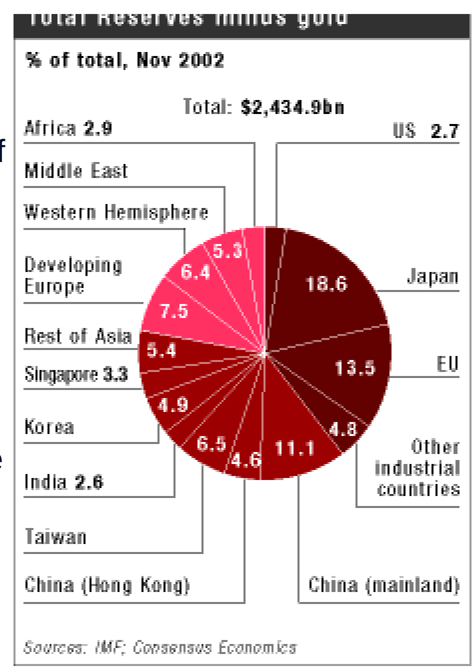
The US is both the world's greatest power and its biggest debtor. This has allowed it to deploy guns and consume butter. As I noted in a previous column ("The rake's progress of the dollar comes under threat", January 8 2003), the US current account deficit is nearly 50 per cent bigger than its defence spending. The question is whether this combination should worry US strategic planners. The answer is that it should: a large and sustained fall in the dollar, along with a reduction in the US ability to run a huge external deficit, would make its role, though affordable, palpably more costly.

Under plausible assumptions, net US liabilities could rise from a little over 20 per cent of gross domestic product at the end of 2001 to over two-thirds by the end of the decade. The current account deficit might well rise from 5 per cent of GDP to as much as 9 per cent. But should these trends reverse, the choice between guns and butter would become immediately painful.

Consider, for example, the cost of the proposed war against Iraq. William Nordhaus of Yale University estimates the direct cost of a war at somewhere between $50bn (£31bn) and $140bn. To this he adds the possible costs of occupation and peacekeeping (between $75bn and $500bn), reconstruction and nation-building (between $30bn and $105bn) and humanitarian assistance (between $1bn and $10bn). Total costs would, therefore, fall between $156bn and $755bn over a 10-year period.*



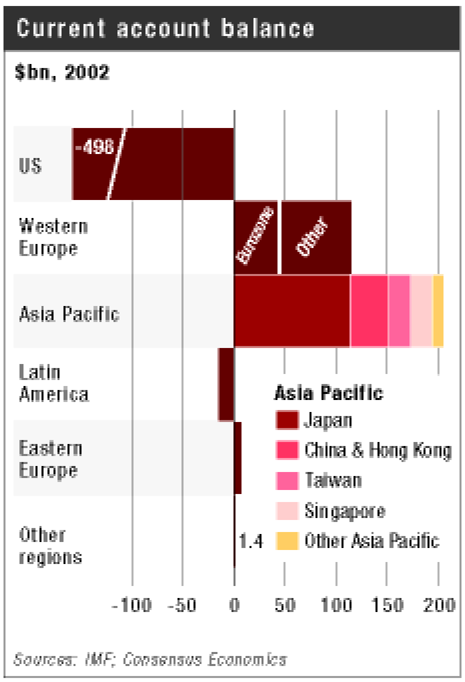
In the 1991 Gulf war, others bore the cost. In effect, the rest of the world hired the US as its mercenary. This time, that is far less likely. If the US went into war without a second United Nations resolution, almost all the burden would fall on the US taxpayer. The combination of a considerably weaker dollar and a falling current account deficit would make these costs more painful, by imposing higher dollar costs abroad and a squeeze on spending at home.

Whether this happens depends on the appetite of the rest of the world for US assets. This, in turn, depends, to a large extent, on Asia. It is the Asians, not the US, who have a "strong dollar" policy, for it is they, together with other foreign investors, who have both the ability and the desire to avoid a fall in the dollar against their currencies. Indirectly, the rest of the world still pays for the exercise of US power.

In 2002, according to the information collected by Consensus Forecasts, the US ran a current account deficit of $498bn. Meanwhile, the Asia

Pacific region ran a surplus of $204bn, contributed largely by Japan, with a surplus of $113bn, Taiwan and mainland China, both with $21bn, Singapore, with $20bn, and Hong Kong, with $17bn (see chart). Western Europe ran a surplus of $115bn, of which the eurozone's share was $45bn, while eastern Europe ran one of $8bn. Latin America ran a small deficit of $15bn, while the rest of the countries covered by Consensus Forecasts ran a small surplus of $1bn.

These figures do not, it should be noted, add up. This is not so much because of countries excluded from the calculations as because of the well known black hole in the global balance of payments. The explanation for this is under-recorded exports, over-recorded imports and associated capital flight, mainly from emerging market economies. One would expect such practices to be particularly common in countries with exchange controls, the most important of which are China and India. This further reinforces the presumption that Asia is the biggest source of US financing.



The picture on current accounts is reinforced by that on official currency reserves. At the end of the third quarter of last year, total foreign currency reserves were $2,294bn, 73 per cent of which were held in dollars. Some 58 per cent of these reserves were held by Asian governments. Japan alone held 19.3 per cent of the total and mainland China another 11.3 per cent.

The sums are staggering: Japan's reserves were $443.1bn, mainland China's $258.6bn and greater China's $526.8bn. The share of Asian economies in incremental reserves has been even larger. Between the end of 1997 and the end of the third quarter of last year, Japan's foreign currency reserves rose by $194bn, while the rest of Asia's rose by $304bn. Together, Asian economies accounted for virtually all the rise in official reserves over that period.

Two forces lie behind these big rises in foreign currency reserves. One is the current account surpluses. The other is the recycling of inward investment. The aim is to preserve export competitiveness, a phenomenon called "exchange rate protectionism" by the Australian international economist Max Corden. Asians provide goods in return for depreciable IOUs denominated in the currency of the debtor. It is a symbiotic, but inherently unstable, relationship. Two other motives have also been at work. In Japan's case, it has been to minimise deflationary pressure. In the case of crisis-hit Asian economies, it was to reduce external vulnerability. South Korea, for example, accumulated $87bn in reserves between 1997 and the end of the third quarter of last year.

These foreign official purchases are crucial. In the first three quarters of 2002, foreign private purchases of US assets ran at an annualised rate of $536bn, a decline of $442bn since 2000. The US private capital outflow also fell by $431bn. Since the current account deficit has been rising, from $410bn in 2000 to close to $500bn last year, increased official purchases of US liabilities have made the difference. These jumped from just $38bn in 2000 to an annualised rate of $86bn in the first three quarters of 2002. Without the exchange rate protectionism of the rest of the world, the dollar would have fallen considerably more than it did.

Can this last? Yes, provided there is no limit to the willingness of the rest of the world to accumulate claims on the US at something close to the present exchange rate. But that is likely to require further large increases in official purchases of US liabilities. This would mainly be done by the Asian mercantilists. In a recent note, the American international economist David Hale argues that Japan's reserves could reach $1,000bn by 2010. If Asians went on buying dollars, much of the adjustment pressure would then fall, willy nilly, on the eurozone.

In military affairs, the US can be unilateralist. But the world of economics is intrinsically multilateral. Those running the world's sole superpower would do well to remember this potentially painful fact.

** "The Economic Consequences of a War in Iraq", in "War with Iraq: Costs, Consequences and Alternatives", www.amacad.org*

This column appears on Wednesdays

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